

Bailey Article

Ideas & trends

By Norman A. Bailey

A safety net for foreign lending

Hundreds of billions of dollars in outstanding loans to developing countries are at risk today. Worldwide recession, falling commodity prices, historically high real interest rates, restraints on commercial bank exposure, and, more recently, the shrinkage of the Eurocurrency market have opened the possibility of a worsening crisis in the international financial system. Neither the willingness nor ability of lenders to maintain their exposure, much less to risk new money, in any way matches the accumulated legal obligations of the borrowers to pay interest and repay principal.

Efforts to meet this unfolding crisis consist mostly of stopgap measures, such as debt reschedulings and emergency bridge loans. These are unlikely to achieve anything more than to delay the onset of a systemic breakdown. What is needed urgently is a new financial instrument that will preserve both the credit standing of debtors and the financial stake of creditors while economic stabilization programs begin to achieve results. The objective should be to create a situation in which the principal repayment claims of creditors are related to a real, measurable ability of debtors to pay. To accomplish that goal, the creation of an instrument that could be called an exchange participation note is needed. Simultaneously, official rescue efforts would concentrate on keeping interest payments current to maintain the liquidity of the system.

These equity-like exchange participation notes would constitute claims on some prudent level of current and future foreign exchange earnings of selected debtor nations. The central banks of these debtor countries would issue the notes to their private and official lenders on a pro rata basis to replace the existing amortization schedules. The central banks of the debtor countries would accept final responsibility for repaying all external debts, public and private, and would act as collection and paying agents. Creditors might form coordinating committees for each debtor country that would be given the authority to act as receiving and paying agent on the lender's side. To reduce complexity, small creditors could be paid off in advance.

Dampening protectionist trends. This solution would offer both debtors and creditors significant incentives, which would work to sustain and increase international trade and investment and to dampen the trend toward protectionist measures.

Consider the proposition from the debtors' point of view. A reasonable share of current and future export earnings would be freed from principal repayment obligations. In the lengthening list of countries where debt service now approaches, equals, or exceeds total export earnings, this would provide immediate relief. Exports could be channeled into productive investment again, and not just dedicated to debt service requirements. As exports increased, with only part of foreign

exchange earnings pledged to redeem the exchange participation notes, the country's ability to borrow for self-financing trade and investment would also increase. Debtors would be offered an attractive alternative to default, repudiation, or ineffective debt reschedulings.

From the creditor's point of view, acceptance of exchange participation notes would be an alternative to additional provisions for loan losses or repeated reschedulings. Bank regulators might regard the notes as a higher quality asset than existing loans. Finally, the notes could be negotiable on the secondary market to an extent to be determined, providing an incentive to trade and spreading risk exposure. The exchange participation notes would reduce the likelihood of defaults, debt moratoriums, or repeated reschedulings.

This instrument would not substitute for increasing quotas at the International Monetary Fund or creating an emergency fund under the General Agreement to Borrow. It would constitute a complementary measure to these steps, which, along with other actions, would still be needed to assure that debtor countries continue to pay interest while the complexities of the new arrangements are worked out. The creation of the notes would provide a much-needed way to deflate the present debt bubble in an orderly fashion. The absence of such constructive alternatives accounts to some extent for the growing lack of confidence in the international banking system.

Rallying point. This proposed innovation has political advantages, too. It would say to Congress that the Administration will not be coming hat in hand for budgetary funds to bail out banks or countries. Few will accept the international banking system as sound or manageable if its survival is maintained on the backs of the taxpayers.

Even more important, this initiative could be a positive rallying point for the trade and financial managers in the Western alliance—one that countries of the North and South could agree on. The South has for years been calling for a "new international economic order," and the North has been resisting. The initiative suggested here could cut through all of that and provide a more realistic basis for future negotiations.

Voices are heard, of course, that want to bring the old order down in favor of a system of collective authoritarian rule in which all financial relations among nations will be rigidly controlled. The audience for these voices grows proportionately as the health of the international trade and banking system worsens. Failing to take effective measures may create a political risk that in more and more countries these voices will come to dominate. If this should happen, we will have succumbed to the notion that credit is only a commodity. We will have forgotten the principle of fiduciary responsibility. None of us should wish to confront the consequences of that.



What is needed is a new financial instrument that ties repayment to a debtor nation's future export earnings and thus to its ability to pay

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Drawing by Arthur K. Miller